Regulated Investment Companies (RICs)

What is a RIC?

- An investment company that invests, reinvests or trades in securities
- At least 100 owners (1940 Act) and public offering intent
- Registers with the SEC under the Investment Act of 1940
- Example: Mutual Fund

RIC Shelter Example

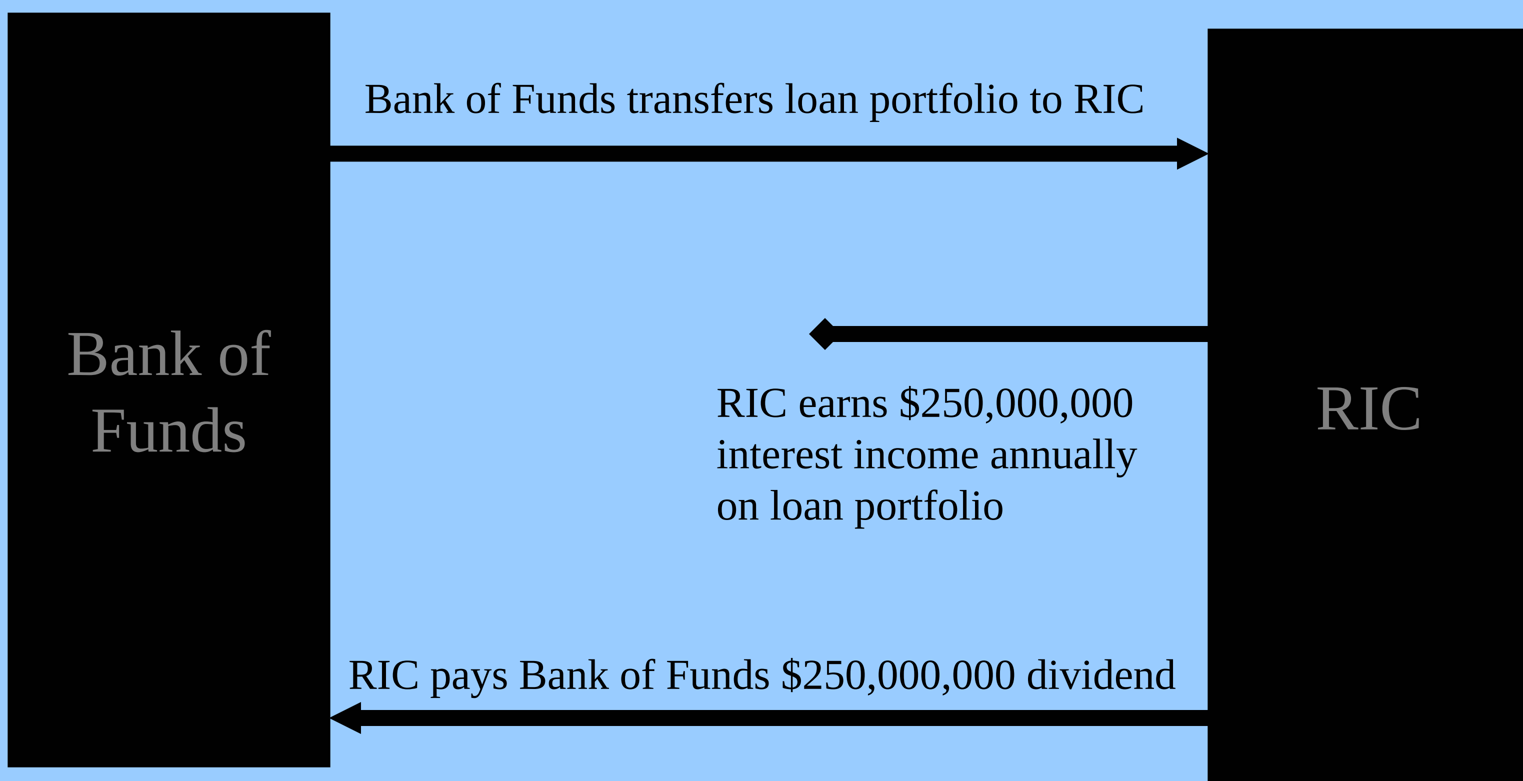
Bank of Funds generates millions in revenue each year and is looking for ways to reduce their resulting tax liability.

Bank of Funds

Annually earns $250,000,000 in interest income on their loan portfolio

Regulated Investment Companies

Bank Of Funds voluntarily registers a RIC with the SEC



RIC’s Position

Interest Income from Loan Portfolio	$250,000,000
Dividend Paid Deduction (DPD)	(250,000,000)
Taxable Income	$0
Tax Liability	$0

Bank's Position

Dividend Income from RIC	$250,000,000
Dividend Received Deduction (DRD) or combined group dividend elimination	(250,000,000)
Taxable Income	$0
Tax Liability	$0

California's Position

- RIC is not valid (sham)
- Bank should be taxed on $250,000,000 of interest income ($250,000,000 x 10.84% bank tax rate x 50% apportionment factor (assumed) = $13,550,000 in tax)

California Fix

- SB 103 (2003)– no R&TC §25106 exclusion (Combined group intercompany dividend elimination)
- Prospective (taxable years beginning on or after 1/1/2003
- “No Inference” Language

Real Estate Investment Trusts (REITs)

What is a REIT?

- Investment company similar to RIC but vast majority of assets are real estate investments.
- At least 100 owners (IRC § 856)

REIT Shelter Example

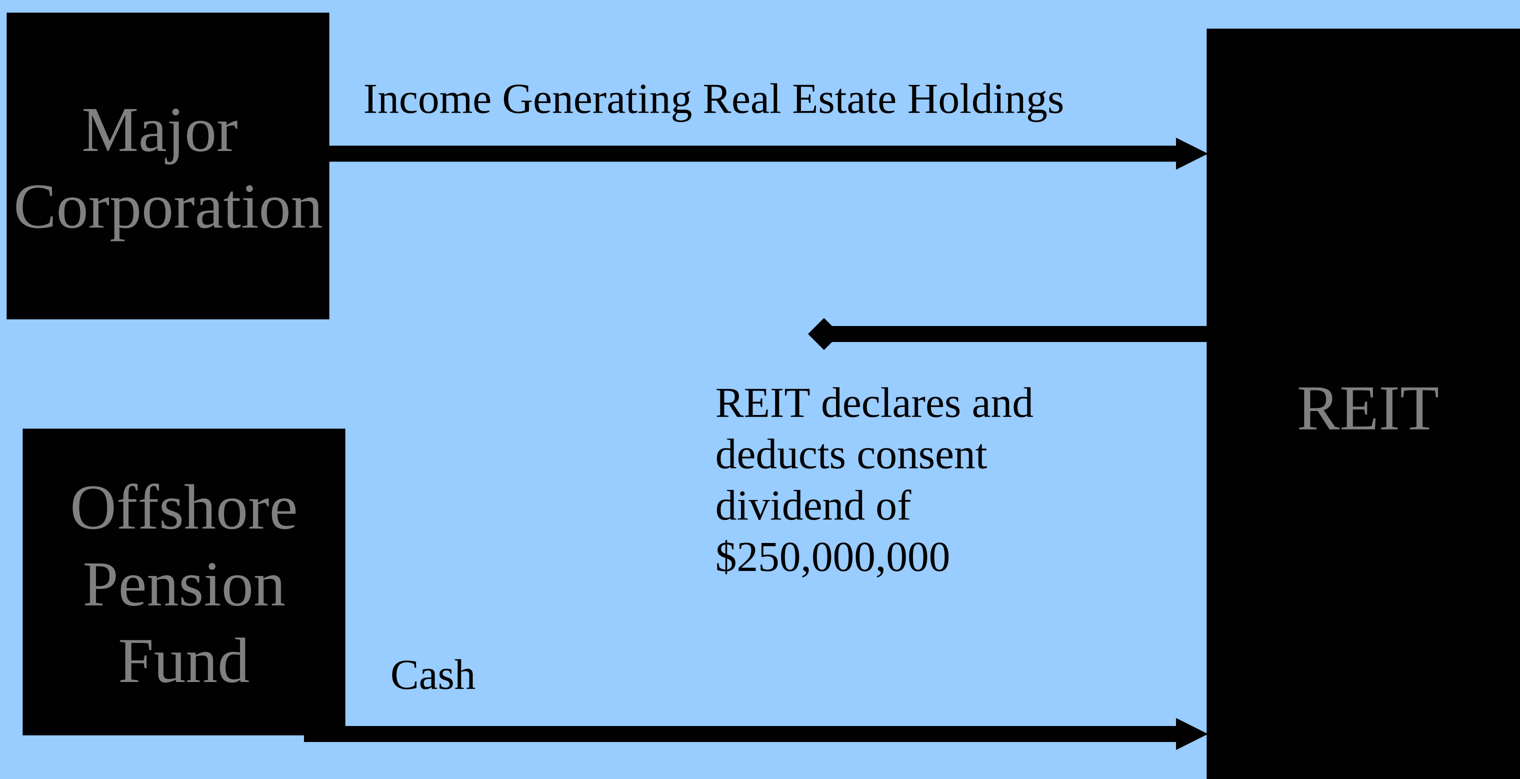
Major Corporation generates millions in revenue each year from real estate activities and is looking for ways to reduce their resulting tax liability.

Major Corporation

Annually earns $250,000,000 in rents from real estate holdings

Real Estate Investment Trust

Major Corporation sets up a REIT subsidiary with an offshore pension trust with over 100 trust beneficiaries. Major Corporation transfers in real estate holdings; pension fund transfers cash.



REIT’s Position

Rental Income from Real Estate	$250,000,000
Dividend Paid Deduction (consent dividend)	(250,000,000)
Taxable Income	$0
Tax Liability	$0

Major Corporation's Position

Dividend Income from REIT (does not include consent dividends)	$0
Dividend Received Deduction	N/A
Taxable Income	$0
Tax Liability	$0

California's Position

- California does not conform to federal consent dividend provisions
- REIT cannot deduct consent dividend for CA tax purposes
- Alternative: If CA has consent dividend for DPD, then by definition, Major Corporation must agree to pay tax on it.

California’s Position

- REIT is not entitled to consent dividend and should thus be taxed on $250,000,000 of rental income ($250,000,000 x 8.84% corporation tax rate x 100% apportionment factor (assumed) = $22,100,000 in tax)

REIT Sourcing Issue

Major Corporation has real property assets in a state and transfers these assets into a holding company.

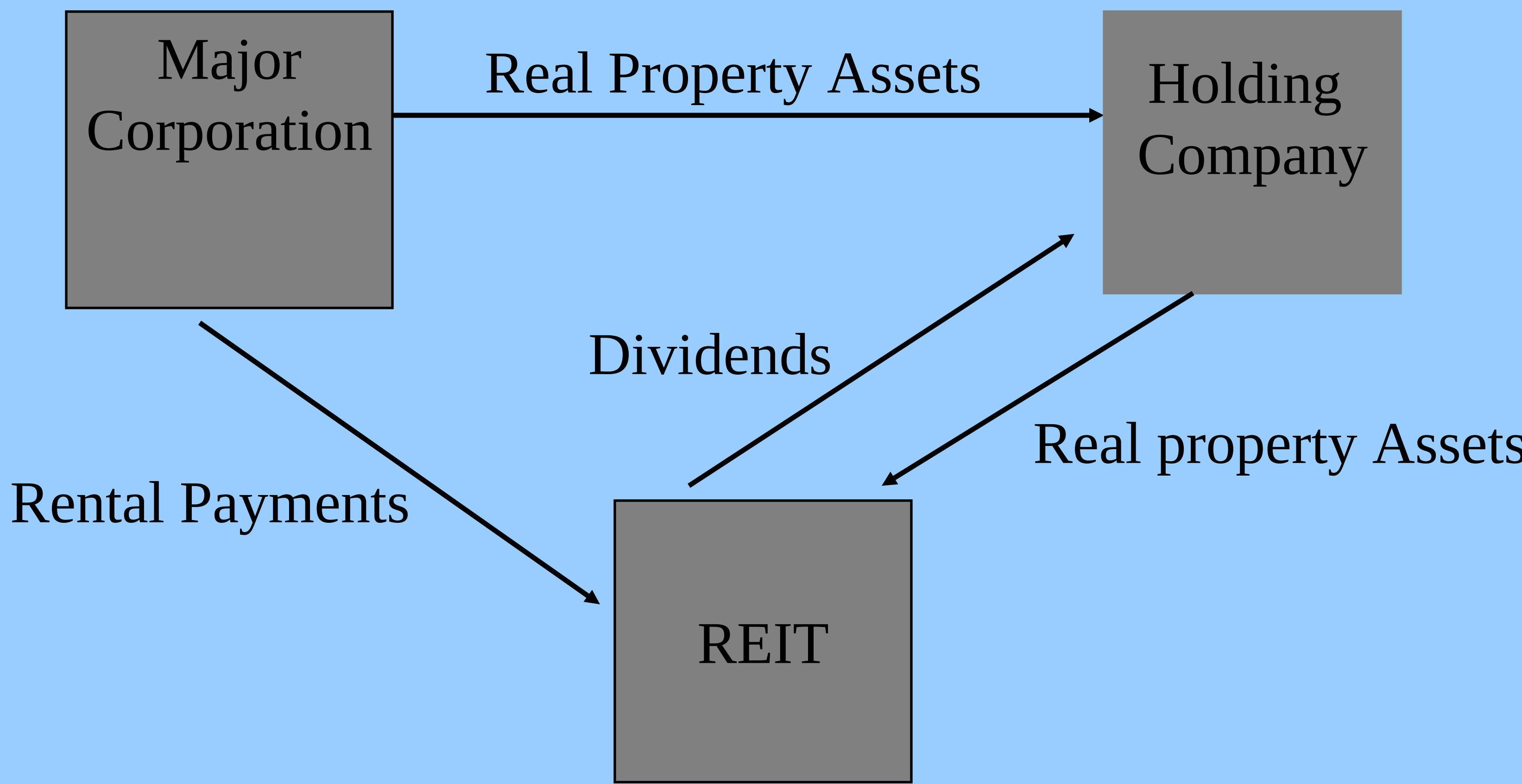
The holding company then transfers these assets to a REIT in exchange for a large interest (almost 100%) in the REIT

The REIT then charges Major Corporation a rental fee for the use of the property.

When dividends are paid from the REIT to the holding company they are deductible to the REIT.

DOES THE HOLDING COMPANY HAVE INCOME IN THE STATE WHERE THE REAL PROPERTY IS LOCATED?

Deal Structure



Major Corporation’s Position

- Payments from Major Corporation to the REIT are deductible rental expenses
- REIT has no taxable income in the state because it receives DPD for dividends sent to the holding company.
- Holding Company does not have nexus in the state where the real property is located, therefore it owes no state tax on the dividend income. (Holding Company only has nexus in state of domicile, usually a state with no state income tax.)

Possible State Positions

- Holding Company has nexus in the state due to the underlying property generating the income which it received as a dividend.
- REIT should be treated as a trust entity rather than a corporation. (IRC Reg. 301.7701-4) This would lead to pass through of income and taxability at the location of the underlying property.
- Sham Transaction. No business purpose for the REIT structure.